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No. 99-663

In the

Supreme Court of the United States

COMMONWEALTH OF PENNSYLVANIA,
DEPARTMENT OF ENVIRONMENTAL PROTECTION,
Petitioner,

v.

JOSEPH P. NIGRO, TRUSTEE FOR THE ESTATE OF
TRI-STATE CLINICAL LABORATORIES, INC.,
Respondent.

On Petition for Writ of Certiorari to the
United States Court of Appeals for the Third Circuit

BRIEF OF THE AMICI CURIAE STATES OF NEW JERSEY, ALASKA, ARIZONA, CALIFORNIA, CONNECTICUT, ILLINOIS, IOWA, MASSACHUSETTS, MICHIGAN, MISSOURI, MONTANA, NEW HAMPSHIRE, NEW YORK, NORTH CAROLINA, NORTH DAKOTA, OHIO, OKLAHOMA, OREGON, RHODE ISLAND, SOUTH CAROLINA, VERMONT, WASHINGTON AND WYOMING IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether noncompensatory criminal fines, imposed on the debtor in possession for violations of environmental laws committed while operating in Chapter 11 of the United States Bankruptcy Code, 11 U.S.C. 101 *et seq.*, constitute administrative expenses "incident to the operation of a business" in that they serve to force the debtor to comply with state environmental law.

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STATEMENT OF INTEREST OF *AMICI CURIAE*

The States have an enormous stake in reversing the judgment of the Third Circuit because it elevates the rights of creditors over the public's right--here enforced by state government--to ensure that companies that violate the environmental laws and endanger public health be held responsible for their conduct. The decision below results in unnecessary interference in the states' criminal justice systems, rendering them impotent in the face of a debtor performing criminal acts while operating under the protection of the Bankruptcy Code.

The outcome of this matter is important to states because the problems encountered in the disposal of solid waste affect every industry and activity in every State of the Union. In the past, unthinking use of the cheapest and easiest means of disposing of wastes led to the creation of hazardous waste sites that have cost the nation and the States billions of dollars to correct. Laws that have been passed since then have attempted to ensure that future disposal activities are conducted in a rational and orderly way that mitigates potential risk to the public and to the environment. The ability of the states to ensure compliance with the laws and regulations that have been enacted to protect the public is, accordingly, a major concern to *Amicus* State of New Jersey and all of the undersigned States.

More generally, the deterrence value of penalties is a necessary aspect of the enforcement of every environmental law. Virtually every state has penalty provisions to deter both ongoing contamination and the refusal to clean up existing contamination. These statutes are effective because they impose substantial penalties on violators and thereby "give teeth" to environmental laws. *State of New Jersey, Dept. of Environmental Protection v. Madison Industries, Inc.*, 161 B.R. 363, 366 (D.N.J. 1993). The temptation to avoid the expenditures required to comply with the law, and to take a chance on remaining undetected, becomes more acute when the operator is under financial pressure. Thus, it

is even more critical to ensure that penalties retain their full deterrent value in those situations. To allow a debtor to operate under the protection of the federal bankruptcy courts while flouting the laws of the state without being subject to effective sanctions is warranted neither by the debtor's desire to reorganize nor by the prepetition creditors' wish for higher payments.

Over a decade ago, in *Midlantic Nat'l Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494, 505 (1986), this Court recognized the critical importance Congress assigned to the "goal of protecting the environment against toxic pollution" and held that "the trustee is not to have carte blanche to ignore nonbankruptcy law." That holding is reinforced by the provisions of 28 U.S.C. Section 959(b), which command the trustee to "manage and operate the property in his possession ... according to the requirements of the valid laws of the State." Id. Penalties are a necessary and integral part of those "valid laws of the State" because of their deterrent function. To maintain that character, penalties must be treated as administrative expenses, rather than general unsecured claims, because there is no requirement that the latter claims be paid at all, much less in full. Unless criminal penalties are treated as priority claims that must be paid in full in order to confirm a plan, the debtor will have little incentive to comply with vitally important--although often expensive--state environmental requirements. And, if its misconduct has no adverse effect on its bankruptcy case, then the debtor will have no incentive to abide by the "valid laws of the State."

The States are also concerned because the court's opinion below conflicts with that of every Circuit Court of Appeals that has decided this issue. The Third Circuit's opinion has taken an area in which there was a clear consensus and has introduced a conflict that will undoubtedly engender new litigation. This litigation can be expected to encompass far more than the conflict between bankruptcy and environmental

law. Penalties are important to encouraging compliance with all areas of the law, both civil and criminal, including vast areas of government regulation in the public interest such as laws regulating securities, banks, taxes, motor vehicles, licensing of all types, and various labor requirements.

Finally, *certiorari* must be granted because the Third Circuit's opinion conflicts with the policy this Court announced in *Kelly v. Robinson*, 479 U.S. 36, 47 (1986). The Court there wrote that the basis for the exception to discharge for criminal sanctions is the "deep conviction that federal bankruptcy courts should not invalidate the results of state criminal proceedings." It added that, "This Court has recognized that the States' interest in administering their criminal justice systems free from federal interference is one of the most powerful of the considerations that should influence a court considering equitable types of relief. This reflection of our federalism must also influence our interpretation of the Bankruptcy Code." Id. at 49 (citations omitted). Those words are a strong reminder of just how strictly this Court has viewed the need to accord respect to the State criminal justice system. By ruling that criminal penalties are only general unsecured prepetition claims that may never have to be paid, however, the Third Circuit has given bankruptcy courts the power to negate the State's environmental enforcement efforts and its criminal justice system.

For the reasons set forth below, the decision of the Court of Appeals for the Third Circuit is incorrect as a matter of law, is unsound as a matter of public policy, and should be reversed. This Court should thus grant *certiorari* to resolve this important issue.

SUMMARY OF ARGUMENT

The Third Circuit's view that a noncompensatory criminal fine cannot be characterized as an administrative

expense because it is not the sort of expense a "legitimate" business would incur as an "actual, necessary cost" of doing business simply misses the point. Whether or not the debtor engaged in a formal "cost-benefit analysis," the result is still the same. The debtor here did not comply with the laws governing the disposal of medical waste and, as a result, became subject to criminal sanctions. The expenses of compliance would undoubtedly have been "actual, necessary costs and expenses of preserving the estate." *See, e.g., In re Wall Tube & Metal Products Company v. State of Tennessee*, 831 F.2d 118 (6th Cir. 1987). By the same token, had the Commonwealth expended its own funds to ensure the proper cleanup and disposal of the waste, the Third Circuit would concededly agree that this expenditure constitutes an administrative expense because it brings the debtor into compliance with the law. *See Pennsylvania Dept. of Environmental Resources ("DER") v. Conroy*, 24 F.3d 568 (3d Cir. 1994).

If, then, the costs of compliance are treated as administrative expenses, it makes no sense to conclude that the costs incurred by the debtor for violating that obligation should have a lower priority. To do so will only encourage debtors to ignore those compliance requirements, because noncompliance will provide additional funds to assist in their reorganization and to benefit their creditors. *See,e.g. In re Charlesbank Laundry, Inc.*, 755 F.2d 200, 203 (1st Cir. 1985); *United States Dept. of Interior v. Elliott*, 761 F.2d 168, 171-172 (4th Cir. 1985).

The Third Circuit's concern that the costs of the debtor's noncompliance are being inflicted upon other creditors is misplaced. If the medical waste had been disposed of lawfully, the bankruptcy estate would have incurred the cost of this disposal and the pool of money that remained after the unlawful disposal would not have been available to the creditors anyway. Whether the debtor complies with the law and incurs costs, or ignores the law and incurs penalties, the

net result is the same -- those monies will be expended and unavailable for payment to the creditors regardless. Put another way, the creditors have no right to insist upon being paid at the expense of the debtor's primary obligation to obey the law during the case.

The decision, though, allows a debtor-in-possession to operate outside the law with impunity, thus giving itself a distinct commercial advantage over those who, operating businesses outside bankruptcy, must comply with the law. Such a result ignores 28 U.S.C.959(b), which requires a debtor or trustee to comply with state law in managing an estate in bankruptcy. *See*, *In re N.P. Mining Co*, 963 F.2d 1449, 1458 (11th Cir. 1992) (trustee is obligated to obey state law including penalty provisions for noncompliance); *Wall Tube*, *supra*, 831 F.2d at 123-24 (finding that trustee or debtor in possession in Chapter 11 as well as in liquidating Chapter 7 case required to comply with state's hazardous waste laws).

Most importantly, the Third Circuit's decision is contrary to that of every other Court of Appeals decision relating to post-petition penalties. *See Cumberland Farms, Inc., v. Florida Department of Environmental Protection*, 116 F.3d 16 (1st Cir. 1997); *Charlesbank*, *supra*, 755 F.2d 200 and *N.P.Mining*, *supra*. *See also Levell v. Karnes*, 143 B.R. 212 (S.D. Ill. 1990); *In re Chateaugay Corp.*, 112 B.R. 513 (S.D.N.Y. 1990), *aff'd* 944 F.2d 997 (2d Cir. 1991); and *In re Bill's Coal Co.*, 124 B.R. 827 (D. Kan. 1991). Cf. *Elliott*, *supra*, 761 F.2d at 171-172 (postpetition penalties are administrative expenses under the analogous provision in Bankruptcy Act); *In the Matter of H.L.S. Energy Co., Inc.*, 151 F.3d 434 (5th Cir. 1998) (costs of compliance are administrative because they preserve estate from being saddled with penalties for noncompliance).

The Third Circuit's discussion (App. 14a-18a[1]) of the prior cases and legislative history dealing with penalties is misplaced because all of the language it relies on deals solely with *prepetition* penalties. Equating the two types of claims ignores the line that the Code draws between the debtor's pre and postpetition activities and the greater rights and obligations of creditors after the petition is filed. *See Elliott*, 761 F.2d at 171 (noting that creditors have means and opportunity to control debtor's actions postpetition and can no longer claim to be mere innocent bystanders). *See* also, *U.S. v. Noland*, 517 U.S. 535 (1996), *rev'g In re First Truck Lines, Inc. (United States of America v. Noland)*, 48 F.3d 210 (6th Cir. 1995) (lower court relied solely on language relating to prepetition penalties to justify equitably subordinating postpetition tax penalties on a wholesale basis).

Clearly, the lower courts need guidance from this Court on these issues and, therefore, this Court should grant *certiorari* to the Commonwealth of Pennsylvania in this matter.

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[1] "App." cites refer to the Petitioner's Appendix.

ARGUMENT

I. POSTPETITION PENALTIES ARE EXPENSES "ORDINARILY INCIDENT" TO THE OPERATION OF THE DEBTOR'S BUSINESS AND SHOULD THEREFORE BE TREATED AS ADMINISTRATIVE EXPENSES

The Code requires that those expenses that "preserve the estate" be given the first priority for payment from the debtor's estate. *See* 11 U.S.C. 503. In addition, Congress has required that a debtor or trustee "shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State," 28 U.S.C. 959(b). Plainly, the costs of compliance with such laws must also come from the assets of the estate, regardless of whether there is an obvious benefit to the estate from doing so.

This Court held over thirty years ago, in *Reading Company v. Brown*, 391 U.S. 471 (1968), that an overly rigid reading of the definition of an administrative expense was unfair to those parties whose claims against the debtor arose postpetition. Where a party voluntarily chooses to do business during that period, it is reasonable to require that it show that the costs it incurs provide a benefit to the estate. But, where the burdens of the estate are "thrust upon" an innocent party, it is inappropriate to impose a strict test of showing benefit to the estate for those costs. 391 U.S. at 478. The Third Circuit had no problem with this analysis with respect to compensatory claims of tort victims (App at 8a to 10a), but, unlike every other Court of Appeals that has considered this issue, viewed the state's claims for administrative status for sanctions for postpetition violations of the law as completely different.

The court could not have thought that the state chose to deal with the debtor or that it could hope to benefit from the debtor's continued postpetition operations, as prepetition creditors might. Nor could the court distinguish penalties on the basis that the cost of paying them would be taken from funds that would otherwise be available for other creditors, since that is, of course, the case wherever *Reading* is applied to give administrative priority to a postpetition creditor. Rather, the Third Circuit simply recoiled from the thought that a "legitimate business" would decide to violate the law rather than to pay the costs of compliance or that Congress could possibly have meant to give priority to the payment of penalties for such violations.

This view of the way that "legitimate" businesses operate simply does not comport with the real world. It is neither novel nor unfair to assume that every business is concerned with the costs of mandated regulatory requirements. Compliance with those obligations will, almost by definition, be more difficult and costly than other means the business might choose to employ – if it were not so, there would be no need to mandate the use of the more protective methods. The purpose of a penalty is to increase the costs of unlawful conduct. One violates the law because the expected benefits of the violation exceed the expected costs. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 164 (1977). Skirting the law subjected the debtor to the risk of sanctions but allowed it to avoid the certainty of the costs of compliance. If the penalties imposed on a debtor are not given administrative status, the economic wisdom of the debtor's gamble becomes irresistible. The cost of complying or the cost of paying the penalty for not complying with the law are equally expenses incident to the operation of the business and must be treated equivalently.

The value of penalties given a priority high enough to ensure their payment cannot be overestimated. The best known way of enforcing laws to protect the public health and

safety is through the assessment of penalties. A debtor's legal obligations to society as a whole should not be subordinated to the particular interest of his creditors. Optimal penalty theory requires that fines be set at a level that fully reflects the costs to society of a prohibited activity engaged in by an economic agent -- either an individual or a firm--if the economic agent nevertheless engages in the prohibited activity. Society must impose penalties on these entities, because, otherwise, these entities would force society to bear the cost of the harms which result from their engaging in a prohibited activity. The optimal level of fines is one that forces economic agents to fully internalize the total cost of their activities rather than transferring those costs to society. Michael K. Block, *Optimal Penalties, Criminal Law and The Control of Corporate Behavior*, 71 BOSTON UNIVERSITY LAW REVIEW 395, 397 (1991). *See also*, POSNER, *supra*.

The potential for sanctions, though, will not necessarily deter a business - particularly one in financial distress - from taking the calculated risk of violating the law in order to avoid those unwanted costs, especially where the harm that may result from the violation is neither immediately apparent nor inevitable. Compliance will *certainly* cause higher costs; noncompliance, if it goes undetected, will cost nothing. To counter that temptation, sanctions are set at a level that will not only compensate for the particular violation but will be large enough that it will have a sufficient deterrent effect. This effect may be particularly critical where the state has no way of assuring that the violation it detected was an isolated incident. A "sanction" that costs the debtor no more than it would have had to pay to comply has no "sting," no "bite" that will serve as a deterrent to future violations.

This tradeoff between fines and compliance costs has been recognized by other Courts of Appeals, whose realistic analysis of these issues stands in stark contrast to the idealized view of businesses indulged in by the Third Circuit. In *Charlesbank*, *supra*, for instance, the First Circuit awarded

administrative expense status to the attorneys fees and costs incurred postpetition by plaintiffs in enforcing an injunction against the debtor. The court noted that, "The debtor in this case *deliberately* continued a violation of law month after month presumably because it was more lucrative for the business to operate outside the zoning ordinance than within it. If fairness dictates that a tort claim based on negligence should be paid ahead of pre-reorganization claims, then *a fortiori*, an intentional act which violates the law and damages others should be so treated." (emphasis in the original). 755 F.2d at 203.

Similarly, in *H.L.S. Energy Co.*, 151 F.3d 434 (5th Cir. 1998), the Fifth Circuit granted administrative expense status to costs that the state incurred when it agreed to close unproductive wells on the debtor's behalf and seek reimbursement. The trustee argued that these costs would not benefit the estate but the court held that the expenses did serve to preserve the estate. Because the debtor was obligated by state law to close the wells, "the unplugged unproductive wells operated as a legal liability of the estate, a liability capable of generating losses in the nature of substantial fines every day the wells remained unplugged." 151 F.3d at 438. Clearly, treating the costs of compliance as an administrative expense would not have benefitted the estate unless the alternative to which the estate would have been subject – the payment of fines – would also have been an administrative expense. See also *Chateaugay*, 112 B.R. at 535 (since debtor was under a continuing obligation post-petition to comply with the environmental laws, compliance costs would be administrative expenses and "for the same reasons, civil penalties for post-petition violations would also be entitled to be treated as administrative expenses.").

This analysis was further articulated by the Eleventh Circuit in *N.P.Mining*, *supra*, 963 F.2d at 1458. It noted that the failure to require a debtor to operate in compliance with the law would provide it with an unfair advantage over its

competitors and would allow it to cut costs by ignoring safety and environmental violations. Accordingly, it concluded that postpetition penalties for noncompliance must be given administrative status to avoid that result. 963 F.2d at 1458-1459. Indeed, it held, this was simply a logical consequence of the application of 28 U.S.C. 959(b). Inasmuch as the debtor must obey state law in operating its business and state law includes both compliance requirements and noncompliance penalties, that is reason enough to treat these payments as required expenses of the estate. *Id.* at 1458.

II. THE THIRD CIRCUIT'S EFFORTS TO DISTINGUISH CONTRARY PRECEDENTS ARE WITHOUT MERIT.

A. Administrative Expense Status for Postpetition Penalties is not Unfair to Other Creditors

The Third Circuit brushed aside the applicability of *Reading*, *supra*, 391 U.S. 471, by asserting that full payment of penalties would unfairly deprive other creditors of their right to payment. That is a criticism that would, of course, apply with equal force to any postpetition payment arising out of the debtor's operations that does not "benefit the estate." As such, it has already been rejected by this Court's decision in *Reading* as to which party should bear the risks of loss from those operations. Even assuming, though, that *Reading* had, *sub silentio,* limited its analysis solely to compensatory claims, the Third Circuit's analysis still misses the mark.

As shown above, penalties and compliance costs are simply opposite sides of the same coin.[2] If that coin is not

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[2] Or perhaps as Justice Scalia asserted in *Florida Prepaid Postsecondary Education Expense Board v. College Savings Bank*, 119 S.Ct. 2219, 2229 (1999), they are the "same side of the same coin."

spent on compliance, it will be owed to the state for penalties and vice versa. Thus, the Third Circuit's assumption that money saved on penalties will inevitably be available for payment to the other creditors simply misses the point. The debtor *should* have spent additional funds on compliance – and, had it done so, the amount available for payment to other creditors would have been reduced, just as is the case if it pays fines for *not* complying. The creditors simply have no equitable right to insist that the debtor need neither comply with the law *nor* pay the price of its violations. See, *e.g.*, *Elliott*, *supra*, 761 F.2d at 171 ("creditors cannot shield their eyes from the debtor's unlawful activities, activities that may benefit the creditors by increasing the distribution to which the creditors are entitled.")

Moreover, as *Elliott* explained, this result is eminently fair because creditors have different roles with respect to pre and postpetition penalties. Prepetition, they have no means of control over the debtor or its actions; postpetition, though, the Code grants them an ability to oversee and inquire into the debtor's affairs. Granting administrative status to penalties incurred postpetition, therefore, ensures that creditors will have a strong incentive to ensure that the debtor complies with the law. "[T]he protection of innocent creditors from penalty claims incurred by an independent [i.e., prepetition] debtor would not be furthered by a holding that permits creditors to benefit from their silence while the [postpetition] debtor violates the law." *Id.* at 172. See also *In re Samuel Chapman, Inc.*, 394 F.2d 340, 342 (2nd Cir. 1968) (liability of estate for tax penalties postpetition "may well result in inducing the general creditors to interest

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Whatever the monetary relationship, they are clearly inextricably intertwined. To be sure, as discussed above, there may not be a one-to-one relationship between the additional costs and the amount of the penalties, but the tradeoff between the two costs is clear.

themselves in the debtor in possession's promptly discharging his duties under the revenue laws.")

B. The Third Circuit's Attempt to Distinguish Between Types of Noncompensatory Penalties is Unreasonable and Unworkable and is Contrary to the Policies of the Code

1. Distinguishing Between Health and Safety Violations and Less Serious Issues is Impractical

Tri-State intentionally violated Pennsylvania's Solid Waste Management Act, putting the public, in general, and the Commonwealth's employees, in particular, at risk by disposing of infectious medical waste illegally in a municipal waste dumpster. The violation was so egregious that the state sought criminal penalties as a response. Despite the need for a strong governmental response, the Third Circuit held that prior cases, such as *N.P. Mining*, *supra*, 963 F.2d 1449, that granted civil penalties administrative expense status, were distinguishable because the violations in those cases did not involve health or safety. Indeed, the Third Circuit asserted, "We are not convinced that [*N.P. Mining's*] holding would be the same if it were faced with the kind of reckless conduct in which Tri-State engaged." App. at 23a.

Thus, under the Third Circuit's analysis, the more serious the violation, the less the consequences should be for the debtor and other creditors. To state the proposition is to demonstrate its absurdity. If Congress deemed it critical that debtors be required to obey the law, as it stated in 28 U.S.C. 959(b), it could hardly have meant that penalties for recordkeeping violations should be given priority (*see Cumberland*) while penalties for violations that resulted in actual and identifiable danger to workers and the general

public - the possibility of being infected with AIDS, hepatitis or other blood-borne diseases - should be relegated to equal treatment with the undifferentiated mass of prepetition claims.

As the Third Circuit recognized, if a fine is treated as a general unsecured claim there is a good chance that no significant payment will be made in most cases. If so, the court's interpretation removes all deterrent value from the imposition of punitive enforcement sanctions for misconduct during the case. Surely, that result is far more inappropriate where the violation is relatively minor and technical than when it is blatant and substantive - and the Third Circuit can point to no other court that supports its counterintuitive analysis. Indeed, despite its reference to *N.P. Mining*, the Eleventh Circuit was quite clear about the fact that it only relied on Section 959 because the state had *not* been able to prove that the violations at issue would create an imminent and identifiable danger. Had there been a safety issue in the case, the opinion would have been far shorter and even more emphatic in its treatment of penalties as priority claims. 963 F.2d at 1457-1458.

Nor, of course, even if one accepted this analysis, is it possible to determine where the line would be drawn. How minor must the violations be before they can be given priority? What if the infectious waste had been found before it spattered the workers? Would this be only an *attempted* safety violation, and therefore appropriate for administrative expense status? Or what if the tubes had broken, but the workers had not been spattered? Would that, nevertheless, be so hazardous that priority should be denied? Can anyone predict in advance?

In short, by creating this distinction, the Third Circuit has created uncertainty where there was none, and has encouraged unproductive and repeated litigation by parties trying to decide where to draw an unrealistic line. Countenancing this result would be both unreasonable and

impractical. This Court should take this case to eliminate the uncertainty that now surrounds this issue and to prevent the endless litigation that will be the result of such uncertainty.

2. The Code Evinces Congress' Intention to Protect State Criminal Proceedings

Moreover, if Congress in fact only intended to give priority to sanctions for relatively minor violations but not for the serious conduct that would give rise to criminal sanctions, one would expect this bias against criminal actions to be apparent elsewhere in the Code. But, to the contrary, there are Code sections that clearly show that Congress intends to treat criminal sanctions and criminal proceedings at least as favorably those involving civil sanctions. Similarly, when this Court held in *Pennsylvania Dep't of Public Welfare v. Davenport*, 495 U.S. 552, 561-563 (1990), that the Code's language allowed criminal sanctions to be discharged in Chapter 13 cases, Congress acted immediately to change that result, while leaving civil penalties still subject to the superdischarge.[3]

This Congressional respect for the results of state criminal cases was best described in *Kelly v. Robinson*, 479 U.S. 36, 47, 49 (1986), where this Court described why it included criminal restitution within the "fine, penalty, and forfeiture" language of Section 523(a)(7), despite the fact that it might not be covered by the "plain meaning" of that section. "Our interpretation of the Code also must reflect the basis for this judicial exception, a deep conviction that federal bankruptcy courts should not invalidate the results of state criminal proceedings. . . . [T]he States' interest in

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[3] *See* 11 U.S.C. §1328(a)(3) (discharge does not include any debt "for restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime").

administering their criminal justice systems free from federal interference is one of the most powerful of the considerations that should influence a court considering equitable types of relief." With this evidence of Congressional solicitude for state criminal proceedings, it makes little sense to suggest that the deterrent effect of criminal penalties should be emasculated by denying them priority status.

III. DENIAL OF ADMINISTRATIVE STATUS TO PENALTIES IS NOT WARRANTED BY THE TREATMENT OF PENALTIES UNDER THE BANKRUPTCY ACT OR BY THE LEGISLATIVE HISTORY OF THE CODE AND IS CONTRARY TO DECISIONS OF THIS COURT AND OTHER COURTS OF APPEALS

The Third Circuit's decision relies heavily on its analysis of the treatment of penalties under the Bankruptcy Act and in the discussions leading up to the passage of the Bankruptcy Code. This analysis is fatally flawed and, in the end, simply irrelevant because all of the language cited has to do with *prepetition* penalties – a point the Third Circuit glosses over until the very end of its analysis. No one disputes that prepetition penalties are not given priority – but that fact simply has no bearing on how Congress intended that *postpetition* penalties should be treated.

Postpetition penalties under the Bankruptcy Act were discussed, however, by the Fourth Circuit in *Elliott supra,* 761 F.2d at 171 – a case which the Third Circuit's opinion neither discusses nor distinguishes. The Fourth Circuit noted, as did the Third Circuit, that Section 57(j) of the Act appeared to preclude even the allowance of any noncompensatory penalty claim, much less grant such a claim priority treatment. Yet, despite that language, this Court twice held that the section had no relevance to postpetition tax

penalty claims. See *Boteler v. Ingels*, 308 U.S. 57, 59-60 (1939) (holding that Section 57(j) only deals with prepetition penalties. "After bankruptcy, it does not purport to exempt the trustee from the operation of state laws, or to relieve the estate from liability for the trustee's delinquencies"); *Nichols v. United States*, 384 U.S. 678, 692-69 (1966). The court in *Elliott* concluded that those two decisions announced a broad rule of interpretation regarding Section 57(j) and, accordingly, a postpetition claim for a nontax penalty could also be allowed and given priority status. The Third Circuit's holding to the contrary is thus in conflict with both this Court's prior holdings and the decision in *Elliott*.

Nor is there any greater merit to its analysis of the discussions leading up to the passage of the Bankruptcy Code. Again, that language dealt with prepetition penalties and, just as with Section 57(j), there is no reason to assume that Congress meant to extend that treatment to postpetition violations by the debtor. Indeed, it was precisely reliance on that same overly broad reading of this legislative history that convinced the Sixth Circuit in *Noland*, *supra*, 517 U.S. 535, to ignore the explicit language in the Code that gave administrative expense status to tax penalties and, instead, to create a general rule that such penalties should be equitably subordinated.[4] This Court reversed that decision and should grant *certiorari* to this matter and do the same here.

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[4] The Third Circuit argued that the explicit reference to tax penalties in Section 507(b)(1)(C) implied that other penalties should not receive that status. (App. 7a, n. 4). While that is a possible inference, an equally likely one is that courts might be more willing to subordinate penalties that relate solely to the government's pecuniary interests, as opposed to those based on health and safety violations. Thus, Congress might have felt there was a greater need to instruct the courts on the proper treatment of postpetition tax penalties. In any event, in the absence of any discussion of this point by Congress in the Code's legislative history, one can only speculate on its motives.

CONCLUSION

For all of the forgoing reasons, the *amici* States respectfully request that the Court grant the writ of *certiorari* in this case.

Respectfully submitted,

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